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SUBJECT: SRI LANKA: AMBASSDOR EXPRESSES CONCERN ABOUT
SUPREME COURT HEDGE INTERIM ORDER

REF: COLOMBO 1107

Classified By: Ambassador Robert O. Blake, Reasons 1.4 (b, d, e)

¶1. (SBU) Ambassador met with Central Bank Governor Nivard Cabraal on December 9 to express concern about the Supreme Court's interim order halting CPC hedge payments to banks (reftel). Ambassador noted that the ruling not only causes difficulty for Citibank and the other banks involved, but could negatively affect Sri Lanka's ability to access commercial loans in an already tight market.

¶2. (C) Cabraal appeared unconcerned about the short and medium term ramifications of the Supreme Court order. He noted that -- as ordered by the Supreme Court -- the bank is investigating the CPC hedge deals. He told Ambassador that the Central Bank had actually started an investigation on November 11, several weeks before the Supreme Court interim order. He said that he is not getting involved with the investigation itself, but is working to ensure that his Central Bank team is doing a "good technical job" in preparing their report for submission to the Monetary Board. "Let the ramifications be felt thereafter," he added.

¶3. (C) When asked about the likely outcome of the investigation, Cabraal declined to answer. He did note, however, that the Monetary Board is not required to report its findings to the Supreme Court, as the interim order only instructed it to conduct an investigation. Cabraal said that he nevertheless hopes to submit a report to the Supreme Court -- if possible before December 15, when the court will next take up the issue -- to ensure transparency.

¶4. (S) Ambassador repeatedly stressed the international ramifications that could affect Sri Lanka in light of the Supreme Court's action. The government, which at present will not consider working with the IMF, hopes its foreign reserve, balance of payments, and deficit concerns can be solved in other ways. Cabraal said that the government is pursuing raising funds bilaterally (likely from China or Iran), will open new avenues to encourage diaspora investments, and ease transfers to encourage additional migrant worker remittances. When asked directly about the likely devaluation of the rupee, Cabraal refused to comment, but hinted that a devaluation is forthcoming. (Note: Mahen Dayananda (protect source), an influential businessman and immediate former Chairman of the Ceylon Chamber of Commerce, told Econ Chief on December 10 that he expects a devaluation from 110 (at present) to as much as 125. This is what he, and the other stakeholders and academics of the seven-member Consultative Committee advising the Monetary Board, recently recommended. The committee advised a phased devaluation period vice an immediate devaluation, which they fear would cause panic in the market. The Monetary Board may act, or ignore, their advice. End note.)

¶5. (C) COMMENT: Cabraal's claims that he is not involved in the investigation is merely an attempt to protect himself from the various calls for his resignation. He will likely weather this storm with his job intact; prospects for Citibank and others, however, are not as clear. Citibank and the other banks remain in a pessimistic "wait and see" mode,

but Citibank is preparing for action. Dennis Hussey, Country Manager for Citibank, told Econ Chief on December 10 that it will likely start the process to pursue arbitration even before a final ruling. The interim ruling is basis enough under their contract, and the bank needs to do what is necessary to protect its interests. In addition to being worried about a negative decision by the Supreme Court, Hussey is also concerned that the Court could drag out the case for several months, causing a solvency problem for the banks. As Hussey described, Central Bank rules require banks to provision fifty-percent against anticipated loan losses, which with the missed payment from the Ceylon Petroleum Corporation on December 5 is already USD 10.5 million. If the case drags on, Citibank could be required to provision against USD 200 million (i.e., USD 100 million), which would make the branch insolvent. End comment.

Blake